Supreme Court, U. S.
FILED
JUL 26 1974
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 74-22[illegible]

IVAN ALLEN COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. _____

IVAN ALLEN COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner Ivan Allen Company respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered in this proceeding on May 3, 1974.

OPINIONS BELOW

The opinion of the Court of Appeals, reported at 493 F.2d 426 (5th Cir. 1974), appears in Appendix I hereto. The opinion of the United States District Court for the Northern District of Georgia is reported at 349 F.Supp. 1075, and a copy thereof is included in Appendix II.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on May 3, 1974, and this petition for certiorari is filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Whether, in determining the amount of the Taxpayer's net liquid assets at the close of each of the suit years, for purposes of determining the applicability of section 533(a) of the Internal Revenue Code of 1954, the Taxpayer's marketable securities should properly be taken into account at their cost, as the Taxpayer contends, or at their fair market value (less the cost of converting them into cash), as the Government contends.

STATUTORY PROVISIONS INVOLVED

INTERNAL REVENUE CODE of 1954, as amended, United States Code, Title 26:

"§531. *Imposition of accumulated earnings tax.*

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27 1/2 percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38 1/2 percent of the accumulated taxable income in excess of $100,000.

"§532. *Corporations subject to accumulated earnings tax.*

(a) *General rule.*

The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other

corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * *

"§533. *Evidence of purpose to avoid income tax.*

(a) *Unreasonable accumulation determinative of purpose.*

For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

* * *

STATEMENT OF THE CASE

This is a tax refund suit involving the application of sections 531-537 of the Internal Revenue Code of 1954, as amended, which impose a penalty tax on corporations "formed or availed of for the purpose of avoiding the income tax with respect to . . . [their] shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." Petitioner filed the instant civil action on the ground that accumulated earnings taxes and interest were erroneously and illegally assessed against and collected from it for its taxable years ended June 30, 1965 and June 30, 1966.

Petitioner (hereinafter referred to as "Taxpayer") is an active operating company engaged in the business of selling office supplies and equipment in the metropolitan area of Atlanta, Georgia. As of the last day of each of the taxable years in question, Taxpayer held certain marketable securities. These securities, however, repre-

sented an investment of less than seven percent of Taxpayer's total undistributed earnings and constituted less than five percent of Taxpayer's total assets for each of the years in question, as shown by the following table:

Year Ended	Earnings and Profits Invested in Securities	Total Earnings and Profits	Total Assets
6/30/65	$154,222	$2,200,184.77	$3,717,835.18
6/30/66	$135,754	$2,360,146.52	$4,166,439.83

This litigation is attributable solely to Taxpayer's relatively small investment of a portion of its earnings and profits in marketable securities of a single corporation—Xerox Corporation. As of June 30, 1965, Taxpayer had invested $116,701 of its undistributed earnings and profits in Xerox common stock and $30,625 in convertible debentures issued by that corporation. The stock market quotations on the same day showed Xerox common stock trading at a price that reflected unrealized appreciation in the "value" of Taxpayer's invested earnings and profits of $1,474,623 (market value of $1,621,949 less cost of $147,326). Similarly, at the close of its taxable year 1966, Taxpayer's $133,104 of undistributed earnings and profits invested in Xerox securities appeared to have an unrealized paper appreciation of $2,416,281 (market value of $2,549,385 less cost of $133,104).

On the basis of these undisputed facts, the parties entered into a stipulation in the District Court for purposes of determining the legal issue of the applicability of the tax avoidance presumption provided in section 533(a). In this regard it was stipulated that Taxpayer had a need for operating capital to finance legitimate business operations in the amount of $1,198,309 at the close of its taxable year 1965 and in the amount of $1,455,222 at the close of its taxable year 1966. The stipulation further provided

that if Taxpayer's marketable securities are "taken into account" for purposes of section 533(a) at their "cost," which is the extent to which such securities represent an investment of Taxpayer's earnings and profits, then Taxpayer's net liquid assets exactly equaled its business needs. Accordingly, the government conceded, both in the District Court and on appeal, that if "cost," i.e., earnings and profits, is the standard against which business needs are to be measured, then Taxpayer was justified in retaining a portion of its earnings for its taxable years 1965 and 1966 to meet its business needs and that the accumulated earnings tax was erroneously and illegally assessed against and collected from Taxpayer. If, on the other hand, Taxpayer's investments are required to be taken into account on the basis of their net liquidation value (fair market value less cost of conversion into cash), then Taxpayer conceded that it was subject to the section 533(a) tax avoidance presumption for both its taxable years 1965 and 1966.

The District Court resolved this legal issue in favor of Taxpayer, holding that neither the statute nor any Treasury Regulation required that a taxpayer finance current operations out of unrealized appreciation in the value of its assets, as opposed to earnings and profits. In so holding, the District Court followed the holding of the Maryland District Court in *American Trading & Production Corp.* v. *United States,* 362 F.Supp. 801 (D.Md. 1972), later affirmed by the Fourth Circuit, 474 F.2d 1341 (4th Cir. 1973).

On appeal, the Fifth Circuit reversed the judgment entered in Taxpayer's favor, holding that appreciated assets must be accounted for at their liquidation value as of the last day of the taxable year for purposes of determining the applicability of the section 533(a) tax avoidance presumption.

REASONS FOR GRANTING THE WRIT

1. The Decision of the Fifth Circuit Conflicts in Principle with the Decision of the Fourth Circuit in American Trading & Production Corp. v. United States.

Section 531 of the Internal Revenue Code of 1954 imposes a penalty tax on every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed," and by virtue of section 533(a), such a tax avoidance purpose is presumed if a corporation "permits its earnings and profits to accumulate beyond the reasonable needs of the business."

Although both the statute and the Treasury Regulations make reference exclusively to "earnings and profits," the Fifth Circuit nevertheless concluded in the instant case that the unrealized appreciation in a corporation's assets must be added to earnings and profits in determining the applicability of the section 531 penalty tax. In so holding, the Fifth Circuit noted that the District Court's contrary conclusion was "supported" by *American Trading & Production Corp.* v. *United States*, 362 F.Supp. 801 (D.Md. 1972), *aff'd*, 474 F.2d 1341 (4th Cir. 1973). In *American Trading*, the Fourth Circuit affirmed a decision of the Maryland District Court for the "reasons sufficiently stated in the opinion of the District Court," and thereby adopted the opinion of the District Court.[1]

1. The Fourth Circuit's affirmance of the District Court opinion in *American Trading* is not reported. For this reason, the full text of the Fourth Circuit's per curiam decision is included in Appendix III.

The taxpayer in *American Trading* had total accumulated earnings and profits in the range of $10 million. 362 F.Supp. at 807. In addition, it held marketable securities having a fair market value in excess of $100 million and had demonstrated business needs of approximately one-tenth of that amount. 362 F.Supp. at 809. As in the instant case, the taxpayer's marketable securities in *American Trading* had exhibited substantial unrealized appreciation in value as measured by current stock market quotations.

For all practical purposes, the question presented by *American Trading* was the same as that presented by the instant case—is a taxpayer required by the section 531 penalty tax to finance current business needs out of unrealized appreciation in the value of its assets, as opposed to financing such needs out of earnings and profits.

In *American Trading* the Court confronted this issue squarely and held as follows:

> "[T]he purpose of the Internal Revenue Code Sections in issue, in this Court's view, relates to *earnings and profits* and the size thereof, if any, and not to original capital and the size or growth thereof.
>
> • • •
>
> "Essentially, what has happened is that the original capital in the form of which it is now held has explosively increased in value, but that fact alone is not sufficient in this court's view to require the liquidation of any part of that capital to meet current business needs in order to avoid a Section 531 tax.
>
> • • •
>
> "This Court does not believe the law requires or allows the Court to say to the taxpayer that it must directly utilize for borrowing the other one-half [of

its appreciated assets], rather than part of the earnings and profits of any year in order to escape Section 531 tax." 362 F.Supp. at 808-809.

It was this rationale and principle of law with which the District Court agreed and relied upon in the instant case, but which the Fifth Circuit rejected.

It has been suggested that the holding of *American Trading* is distinguishable from the instant case in that the appreciated property held by the taxpayer in *American Trading* was "original capital." Taxpayer respectfully submits, however, that this factor has no independent significance, either legally or as a matter of practical business judgment. If the sole test of applicability of the section 533(a) tax avoidance presumption is corporate liquidity, as the Fifth Circuit says, then appreciated property originally acquired by means of a capital contribution contributes just as much to that liquidity as appreciated property subsequently acquired by a minor investment of earnings and profits. Indeed, in *Golconda Mining Corp.*, 58 T.C. 736 (1972), on appeal (9th Cir. Appeals Nos. 72-3202, 73-1161 and 73-1162), which involved the precise issue presented by the instant case, the Tax Court, although it agreed with the government's position, recognized that there was no distinction between unrealized appreciation in assets contributed to a corporation as part of its original capital and unrealized appreciation in liquid assets obtained by an investment of earnings and profits. In effect, the Tax Court in *Golconda* did not purport to distinguish *American Trading* on any ground whatsoever but simply recognized that its decision was in fundamental conflict with the *American Trading* decision. Taxpayer understands that the *Golconda* case, which was relied upon by the Fifth Circuit in the instant case, has been orally argued in the Ninth Circuit and is awaiting decision.

Under the Tax Court's rule of following the decision of the Circuit to which appeal will lie, *Jack E. Golsen*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971), the Tax Court, in cases where appeal will lie to the Fourth Circuit, as well as all District Courts within the Fourth Circuit, will follow the holding of *American Trading*. Meanwhile, taxpayers in the Fifth Circuit will be restricted and required to govern their business decisions by the Fifth Circuit's decision in the instant case.

In view of the immediate impact of the Fifth Circuit's decision upon practical and important business decisions of taxpayers in that Circuit as well as the unfairness of a different standard being applied to Fourth Circuit taxpayers similarly situated, Taxpayer respectfully submits that this conflict justifies the grant of certiorari to review the judgment below.

2. The Fifth Circuit's Decision Raises Important and Recurring Problems in Judicial and Administrative Application of the Section 531 Penalty Tax.

The manner in which a taxpayer's liquid assets are to be taken into account for purposes of determining the applicability of the section 533(a) presumption is a substantial and frequently recurring issue, the resolution of which is crucial to the administration of the accumulated earnings tax. Even before this Court's decision in *United States* v. *Donruss Co.*, 393 U.S. 297 (1969), and certainly since that decision, litigation involving the accumulated earnings tax has focused almost exclusively upon the issue of whether an unreasonable accumulation of earnings exists. This shift in focus has effectuated the policy of Congress, as interpreted by this Court, by emphasizing an "objective inquiry" that is "susceptible of more effective scrutiny,

than are the vagaries of corporate motive." 393 U.S. at 307. Thus, when a taxpayer can demonstrate that its business needs exceed its accumulated earnings and profits, the government has ordinarily conceded or suffered defeat. *See, e.g., Electric Regulator Corp.* v. *Commissioner*, 336 F.2d 339 (2d Cir. 1964); *R. Gsell & Co., Inc.* v. *Commissioner*, 294 F.2d 321 (2d Cir. 1961); *John P. Scripps Newspapers*, 44 T.C. 453 (1965). Conversely, when an accumulation of earnings has been found to be unreasonable, taxpayers have rarely succeeded in rebutting the inference that tax avoidance was the motive for the accumulation. *See, e.g., I. A. Dress Co., Inc.* v. *Commissioner*, 273 F.2d 543 (2d Cir. 1960); *Ted Bates & Co., Inc.*, 24 T.C.M. 1346 (1965).

Because of the dominant role that the section 533(a) presumption has assumed in the administration of the accumulated earnings tax, the instant case, which presents a recurring issue in determining the applicability of the presumption, is of utmost importance. Indeed, Taxpayer is aware of two pending cases which involve precisely the same issue presented by the instant case. *Golconda Mining Corp.*, 58 T.C. 736 (1972), on appeal (9th Cir. Appeals Nos. 72-3202, 73-1161 and 73-1162); *Space Center Incorporated*, Tax Court Case No. 1325-73. In addition, there have been numerous cases in which the issue presented by the instant case has been presented and decided both with and without discussion as well as a number of cases in which the issue has been presented but its resolution was not necessary to the decision in the case. See Appendix IV.

In short, both taxpayers and the government, as well as the lower courts, urgently need a resolution of the issue presented by the instant case, for the Fifth Circuit's

resolution of the issue not only departs from the clear purpose of the accumulated earnings tax but also presents practical problems in the administration of the tax.

By its plain terms, the applicability of the section 533(a) presumption is dependent upon a comparison of a corporation's accumulated earnings and profits with its reasonable business needs. The question presented by the instant case turns on the first half of this equation and more particularly on the appropriate method by which the amount of a taxpayer's accumulated earnings and profits available to meet its business needs should be determined. Since the Fourth Circuit's decision in *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960), this determination has been made by calculating the amount of a taxpayer's earnings and profits invested in liquid assets unrelated to the corporation's trade or business. Such a calculation quite properly recognizes that to the extent that a taxpayer has invested its accumulated earnings in liquid assets unrelated to its business, its earnings are available either to meet its business needs or for distribution as dividends to its shareholders.

The Fifth Circuit, however, has concluded that the amount of a taxpayer's accumulated earnings and profits available to meet its business needs should be determined by calculating the fair market value of the taxpayer's liquid assets rather than the accumulated earnings invested in such assets. In so holding, the Fifth Circuit has adopted a standard that deviates from the clear congressional purpose of penalizing a taxpayer solely for unreasonably accumulating its *earnings and profits*. This purpose is manifested not only in the operative provisions of the tax, all of which are structured around a taxpayer's accumula-

tion of earnings and profits,[2] but also in the legislative history of the tax.[3] Indeed, it is in recognition of this purpose that Treasury Regulation §1.535-3(b)(1)(ii) omits any reference to the unrealized appreciation in a corporation's assets and provides simply that in determining whether earnings and profits have been accumulated beyond the reasonable needs of the business, "*the accumulated earnings and profits of the prior years* will be taken into consideration." *See also,* Treas. Reg. §§1.533-1(a)(1), 1.533-1(b), and 1.537-2.

The Fifth Circuit, however, by requiring that a corporation's liquid assets be taken into account at their fair market value, has reached a conclusion that will make the application of the section 531 penalty tax turn on the market value of a corporation's liquid assets as of the last day of its taxable year without regard to the size and nature of the corporation's accumulation of earnings. Such a result, which departs from the clear statutory standard of "accumulated earnings and profits" and substitutes a standard dependent upon the state of the local, national and world economic and political situations as

2. *See, e.g.,* section 532 (tax applies to every corporation permitting its *earnings and profits* to accumulate for the tax avoidance purpose); section 533 (presumption of tax avoidance applies if *earnings and profits* are permitted to accumulate beyond the reasonable needs of the business); section 535(c)(1) (a credit allowed against accumulated taxable income for *earnings and profits* retained for the reasonable needs of the business); section 535(c)(2) (a minimum credit allowed against accumulated taxable income for $100,000 of *earnings and profits*).

3. S. Rep. No. 1567, 75th Cong., 3d Sess. 5 (1938) (stating that the purpose of the section 533(a) presumption is to require a taxpayer to prove the absence of any tax avoidance motive "*after it has been determined that the earnings and profits have been unreasonably accumulated*"); S. Rep. No. 2156, 74th Cong., 2d Sess. 17 (1936) (explaining the 1938 amendment of the statute to substitute the phrase "earnings and profits" for "gains and profits" as more accurately describing "the fund out of which tax dividends are paid").

of a particular day in a corporation's taxable year, was clearly not contemplated by Congress. *Contra, Harry A. Koch Co.* v. *Vinal,* 228 F.Supp. 782 (D.Neb. 1964).

Moreover, the Fifth Circuit's opinion ignores the effect its conclusion will have on the administration of the accumulated earnings tax. If a corporation's investments in assets unrelated to its trade or business consist of stock of closely held corporations or real estate for which there is not a ready market, the applicability of the section 533(a) presumption and thus the corporation's liability for the accumulated earnings tax will turn on complex questions of valuation. Introducing this element into the section 531 penalty tax will not only thrust these questions of valuation upon the judiciary but will also create substantial uncertainty among taxpayers as to their exposure to the tax. Such a result is contrary to the policy set forth in this Court's decision in *United States* v. *Donruss Co.,* 393 U.S. 297 (1969), which placed primary emphasis on readily ascertainable objective criteria as the determining factors in the administration of the tax. Indeed, the standards for determining the applicability of a penalty tax should clearly be more precise than the varying opinions men may have as to the value of a corporation's assets.

Finally, the Fifth Circuit's opinion will have far-reaching and detrimental effects on the exercise of corporate management's business judgment. The opinion requires that a corporation with appreciated liquid assets must take this appreciation into account as a source of funds available to finance its business needs. By so holding, the Fifth Circuit has in effect told corporate management that in order to avoid exposing their corporations to the section 531 penalty tax they must liquidate corporate investments to finance business needs, even though management in

the exercise of its business judgment may feel that its needs should be financed out of current and accumulated earnings. Such a result not only unjustifiably interferes with legitimate corporate business decisions without in any way furthering the purpose of the accumulated earnings tax, but also departs from the well-established principle that a corporation may legitimately finance its business needs and expansion *solely* out of current and accumulated earnings and profits without regard to other available sources of funds. *See, e.g., Duke Laboratories, Inc.* v. *United States,* 337 F.2d 280 (2d Cir. 1964); *Electric Regulator Corp.* v. *Commissioner,* 336 F.2d 339 (2d Cir. 1964); *John P. Scripps Newspapers,* 44 T.C. 453 (1965); *Carolina Rubber Hose Co.,* 24 T.C.M. 1159 (1965); *General Smelting Co.,* 4 T.C. 313 (1944).

CONCLUSION

For the reasons stated above, a writ of certiorari should issue to review the judgment and opinion of the Fifth Circuit.

Respectfully submitted,

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APPENDIX

APPENDIX I

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

October Term, 1973

No. 73-2866

D. C. Docket No. CA 15130

IVAN ALLEN COMPANY,
Plaintiff-Appellee,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court
for the Northern District of Georgia

Before GODBOLD, SIMPSON and INGRAHAM,
Circuit Judges.

Judgment

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Georgia, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed; and that this cause be, and the same is hereby remanded to the said District Court for the additional factual determination of whether one purpose for the accumulation was to avoid income tax on behalf of the shareholders in accordance with the opinion of this Court;

It is further ordered that plaintiff-appellee pay to defendant-appellant, the costs on appeal to be taxed by the Clerk of this Court.

May 3, 1974

Issued as Mandate:

IVAN ALLEN COMPANY, Plaintiff-Appellee,

v.

UNITED STATES of America, Defendant-Appellant.

No. 73-2866.

United States Court of Appeals, Fifth Circuit.

May 3, 1974.

In proceedings concerning propriety of application of accumulated earnings tax penalty, the United States District Court for the Northern District of Georgia, at Atlanta, Charles A. Moye, Jr., J., 349 F.Supp. 1075, concluded that securities purchased by a corporation should be valued at original cost for purposes of determining whether the corporation had accumulated excess earnings. The government appealed. The Court of Appeals, Ingraham, Circuit Judge, held that the proper valuation of the securities was their fair market value less the expense of their conversion into cash, and remanded the case for a determination as to whether one of the purposes for the accumulation had been to avoid income tax on behalf of the shareholders.

Reversed and remanded.

Internal Revenue (Key) 763.1

For purposes of determining whether corporation had accumulated excess earnings, correct evaluation for substantially appreciated securities held by corporation was fair market value less expense of conversion into cash, not original cost to corporation. 26 U.S.C.A. (I.R.C. 1954), §§ 531, 532, 533(a).

Appeal from the United States District Court for the Northern District of Georgia.

Before GODBOLD, SIMPSON and INGRAHAM, Circuit Judges.

INGRAHAM, Circuit Judge:

The issue on this appeal concerns the standard for measuring the amount of a corporation's liquid assets in determining the applicability of the tax imposed upon a corporation for not distributing to its shareholders the earnings and profits that exceed its reasonable business needs.[1] More specifically, we must decide whether securities, which have appreciated substantially in value, should be measured by their original cost to the corporate taxpayer, or at the fair market value less the expense of conversion into cash. The district court held for taxpayer Ivan Allen Company, concluding that liquid assets would be measured at their original cost. Ivan Allen Co. v. United States, 349 F.Supp. 1075 (N.D.Ga., 1972). We do not agree with the district court's disposition of this case and therefore reverse.

The stipulated facts demonstrate that since 1902 Ivan Allen Company, a Georgia corporation, has sold office machinery and supplies in and around Atlanta, Georgia. In the late 1950's or early 1960's the corporate management recognized the great potential in Xerox Corp. securities and invested about $218,180 in them. Ivan Allen obviously made a wise investment because, since the purchase of the securities, their value has increased about ten times

1. Section 531 of the Internal Revenue Code imposes the accumulated earnings tax on any corporation that, according to § 532, is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." 26 U.S.C. §§ 531, 532.

the original cost. It is the substantial appreciation of this stock that gives rise to the present controversy.

The district court, recognizing the varying standards adopted by the courts for measuring the amount of a corporation's liquid assets,[2] concluded that the proper standard was the original cost to the corporation rather than the fair market value. The parties' stipulations, in view of the court's determination, dictated the conclusion that Ivan Allen Co. had not unreasonably accumulated earnings or profits.

The Supreme Court in Helvering v. National Grocery Co., 304 U.S. 282, 58 S.Ct. 932, 82 L.Ed. 1346 (1938), stated that, when determining whether a corporation has withheld earnings in excess of reasonable business needs, "[d]epre-

2. Based on facts similar to those in the case at hand, the Tax Court in Golconda Mining Corp. v. Comm'r, 58 T.C. 139 (1972), supp. opin. 58 T.C. 736 (1972), reached a result contrary to that of the district court. Our decision today brings this court in line with the *Golconda* decision. *Golconda* is currently on appeal to the Ninth Circuit. Also consistent with *Golconda* is the case of Henry Van Hummell, Inc. v. Comm'r, P-8 Memo T.C. ¶ 64,290 (1964), aff'd 364 F.2d 746 (10th Cir., 1966), cert. den. 386 U.S. 956, 87 S.Ct. 1019, 18 L.Ed.2d 102 (1967).

There are two decisions that offer support for the district court's conclusion. American Trading & Prod. Corp. v. United States, 362 F.Supp. 801 (D.Md.1972), aff'd 474 F.2d 1341 (4th Cir., 1973); Harry A. Koch Co. v. Vinal, 228 F.Supp. 782 (D.Neb., 1964). Arguably, the *American Trading* decision, on which the district court heavily relied, is not inconsistent with our conclusion in the instant case. In *American Trading* the corporation, like in the case at hand, had purchased securities that had appreciated substantially in value. The court held that, despite the substantial appreciation in liquid assets, this appreciation was not earnings or profits within the meaning of § 531 because it was derived from the corporation's original capital. Also, because of additional circumstances such as insider trading limitations, the securities were not as liquid as they might be under ordinary circumstances, and therefore were not readily available to meet the corporation's business needs. *See* Comment, Accumulated Earnings Tax: Should Marketable Securities be Valued at Cost or at Fair Market Value in Determining the Reasonableness of Further Accumulations of Income? 40 Brooklyn L.Rev. 192 (1973).

ciation in any of the assets is evidence to be considered . . . ." *Id.* at 291. Implicit in the *National Grocery* decision is the Court's concern with the actual financial status of the corporation and its ability to meet business needs from available resources. Liquidation of depreciated assets may not produce adequate funds to meet needs arising in the course of business.

Unlike *National Grocery*, the liquid assets in the case at hand have appreciated in value rather than depreciated, but the underlying principle is still applicable. Because the liquid assets can be easily converted into cash, the appreciated value of the securities is readily available to meet the business needs of the corporation as they arise. To accurately determine Ivan Allen's ability to meet business needs from its available resources, the appreciated value of the securities must be taken into account. As unrealized depreciation of liquid assets is considered in determining whether a corporation has unreasonably accumulated profits, unrealized appreciation likewise must be considered.

We are supported in this conclusion by our decision in Battelstein Investment Co. v. United States, 442 F.2d 87 (5th Cir., 1971). The taxpayer in *Battelstein* had sold real estate and received in return a partial initial cash payment and a long term note for the unpaid balance. Holding that the discounted value of the note, although yet unrealized gain, should be considered in determining whether the corporation had unreasonably accumulated profits Chief Judge Brown stated:

> "Looking ahead—as the concept of reasonable accumulating contemplates—Taxpayer, as it surveyed the future at FY 1963's end, could not ignore this rich resource. This bluechip note effectually secured by gilt-edged Houston land was then worth not less

> than the discounted value. Granted that for income tax purposes the deferred payments did not constitute 'income' or 'earnings' for FY 1963 the discounted value of this highly liquid asset had to be reckoned with in weighing foreseeable, planned (i) needs against (ii) available resources at the time of need."

Id. at 89. Like the note in *Battelstein*, the securities involved in the case at bar are of such a highly liquid character as to be readily available for business needs that might arise. Thus the appreciated value of these securities should be taken into account when determining whether the corporation has accumulated profits in excess of reasonable business needs.

We are not persuaded by taxpayer's argument that our conclusion to take into account the appreciation of the securities is inconsistent with sound business practices. Because of the day to day fluctuation of the stock market, taxpayer argues, the appreciation of the securities is not truly an available resource for meeting business needs. But while it is true that the stock market is highly unpredictable, we still believe that the fair market value is a closer approximation of available resources than simply the historical cost.

Nor do we think that our decision imposes undue limitations on the exercise of the corporation's sound business judgment in the conduct of its financial affairs. In no way do we attempt to dictate any point in time when appreciated assets are to be sold, exchanged or distributed to the shareholders. This decision does not force the corporation to liquidate these securities at any time when a sale would be financially unwise, but only compels the corporation to comply with the proscriptions of the Code and refrain from accumulating excessive earnings and prof-

its. That taxpayer, as a consequence of its own sound judgment in making profitable investments, must sell, exchange or distribute to the shareholders assets in order to avoid an excessive accumulation of earnings and thus comply with the Code's requirements is no justification for precluding its application.

Having concluded that the proper standard for determining the amount of taxpayer's liquid assets is the fair market value less the expense of converting them into cash, we reverse and remand for the additional factual determination of whether one purpose for the accumulation was to avoid income tax on behalf of the shareholders.[3]

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3. Section 533(a) of the Code provides in part that "the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by a preponderance of the evidence shall prove to the contrary." 26 U.S.C. § 533(a). It has been stipulated that, if the measure for determining the amount of liquid assets is the original cost to the corporation, then the corporation has not unreasonably accumulated earnings. If, however, the measure is determined to be the fair market value less the cost of conversion, then the corporation has accumulated excessive earnings. Because we conclude that the proper measure is the fair market value of the securities, we must remand for additional evidence to see if the taxpayer can prove that the accumulation was not for the purpose of avoiding income tax.

APPENDIX II

IN THE
UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF GEORGIA
ATLANTA DIVISION

CIVIL ACTION NO. 15130

IVAN ALLEN COMPANY,
Plaintiff

v.

UNITED STATES OF AMERICA,
Defendant

Order

(Filed October 6, 1972)

This is a tax refund suit brought by Ivan Allen Company, a Georgia corporation engaged in the office supply and equipment business, to recover federal income and accumulated earnings taxes that it contends were erroneously assessed and collected by the Internal Revenue Service [hereinafter the IRS]. According to a stipulation submitted jointly by the parties, the sole issue presently before the Court concerns the proper interpretation and application of the accumulated earnings tax provisions of the Internal Revenue Code [hereinafter the IRC].

The accumulated earnings tax[1] is a penalty tax imposed on a corporation which has been used to avoid personal incomes taxes[2] on its shareholders by permitting its earnings and profits to accumulate beyond the reasonable needs of its business rather than being divided or distributed. Ivan Allen Company accumulated retained earn-

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1. Sections 531-533 of the Internal Revenue Code of 1954 provide:

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27 1/2 percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38 1/2 percent of the accumulated taxable income in excess of $100,000.

* * *

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) General Rule.—The accumulated earnings tax imposed by Section 531 shall apply to every corporation (other than those described in section (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * *

2. Tax avoidance is possible due to the disparity in tax rates for individuals versus corporations.

ings and invested them in marketable securities. The question before the Court is whether these marketable securities should be accounted for at cost, as the taxpayer contends, or at fair market value (less the cost of converting them into cash), as the government contends, for dedetermining the applicability of the accumulated earnings tax.[3] The government admits that if the Court decides the securities should be accounted for at their cost, the taxpayer's undistributed earnings and profits were not permitted to accumulate beyond the reasonable needs of the taxpayer's business and the full amount of accumulated earnings tax collected must be refunded.

After careful consideration of the accounting principles and tax policies involved, the Court rules for the taxpayer and holds that when computing the taxpayer's net liquid assets for the purpose of determining the applicability of Section 533(a) of the Internal Revenue Code of 1954 the taxpayer's marketable securities should be valued at their cost.[4]

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3. The precise technical legal question presented to the Court is:

> "Whether, in determining the amount of the taxpayer's net liquid assets at the close of each of the suit years, for purposes of determining the applicability of Section 533(a) of the Internal Revenue Code of 1954, the taxpayer's marketable securities should properly be taken into account at their cost, as the taxpayer contends, or at their fair market value (less the cost of converting them into cash), as the government contends." [Stipulation filed jointly by the parties, p. 5, #15, June 12, 1972]

4. The Court specifically limits this decision to value the securities at their cost to situations where the fair market value of the securities is *greater* than cost. The Court in no way implies that marketable securities should be valued at their cost when fair market value is *lower* than cost. That is an entirely different situation which may involve a more complex analysis and different accounting principles.

While the Court is aware of Tax Court decisions which have reached a contrary result,[5] the Court agrees with and prefers to apply the excellent reasoning of Judge Miller in *American Trading and Production Corporation* v. *United States* [Civil No. 70-1266-M (D. Md., May 10, 1972), 29 Am. Fed. Tax. R.2d ¶72-643]. Neither the statute[6] nor the relevant Treasury Regulations[7] suggest that the unrealized appreciation of a corporation's assets should be taken into account for purposes of the accumulated earnings tax. To force a corporate taxpayer to sell part of its retained earnings investment portfolio in order to avoid an accumulated earnings tax because the investments increased in value since purchase is inconsistent not only with sound tax accounting principles but also with better business judgment. Normally, gains are not recognized until realized and in this case the proper value of the securities, until they are converted into cash, is their cost. Corporate taxpayers should not be penalized for wise investments; they should be allowed to maximize their capital gains tax advantages in accordance with internal business policies and stock market conditions rather than being forced to sell securities which may have a high value[8] on an arbitrarily selected date merely because the unrealized fair market value of the securities on that date would trigger the accumulated earnings tax. The value of a particular stock would depend upon a wide array of imponderables relating principally to the condition of the

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5. *Golconda Mining Corporation*, 58 T.C. No. 74 (1972); *Henry Van Hummel, Inc.* v. *Commissioner*, 23 T.C.M. 1765 (1964), *aff'd*, 364 F.2d 746 (10th Cir. 1966).

6. Internal Revenue Code § 531, *et seq.*

7. Treasury Regulations §§ 1.537-1, 1.535-3(b)(1)(ii), 1.533-1(a)(2).

8. A situation which might not have been true a month or even a day before that arbitrarily selected date.

company whose stock was held, and the myriad of factors that affect the stock market itself—such as whether Henry Kissinger should go to Paris on December 30th—all far beyond the control of the company holding the investment. Adoption of the government's position would require businessmen to employ persons specializing in crystal ball gazing rather than sound business management.

Accordingly, the government is ordered to refund all accumulated earnings taxes, including interest thereon, collected for the taxpayer's fiscal years ended June 30, 1965, and June 30, 1966.

SO ORDERED, this 6 day of October, 1972.

/s/ Charles A. Moye, Jr.
United States District Judge

APPENDIX III

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 72-1979

AMERICAN TRADING AND PRODUCTION CORPORATION,
Appellee,

versus

UNITED STATES OF AMERICA,
Appellant.

Appeal from the United States District Court for the District of Maryland. James R. Miller, Jr., District Judge.

(Argued January 10, 1973 Decided April 2, 1973).

Before RUSSELL, FIELD and WIDENER, Circuit Judges.

Thomas L. Stapleton, Attorney, Tax Division, United States Department of Justice (Scott P. Crampton, Assistant Attorney General, Meyer Rothwacks, Issie L. Jenkins, Attorneys, Tax Division, United States Department of Justice, and George Beall, United States Attorney, on brief), for Appellant; John S. McDaniel, Jr. (Carolyn E. Agger, Walter J. Rockler, Steven P. Lockman, Lawrence A. Kaufman, Arnold and Porter and Cable, McDaniel, Bowie and Bond on brief), for Appellee.

PER CURIAM:

This case involves a tax refund suit filed by the taxpayer, American Trading and Production Corporation, in

the district court to recover accumulated earnings taxes which it contends were erroneously assessed and collected under Sections 531 through 537 of the Internal Revenue Code of 1954[1] for the calendar years 1963 and 1964. The district court made detailed findings of fact and concluded that the taxpayer was not availed of for the purpose of avoiding income taxes with respect to its shareholders by permitting its earnings and profits to accumulate instead of being distributed;[2] and that during the years in question the earnings and profits of the taxpayer were not permitted to accumulate beyond the reasonable needs of the business.[3] Upon these findings and conclusions judgment was entered in favor of the taxpayer for both years, whereupon the Government filed this appeal.

The ultimate question whether a corporation is availed of for the purposes proscribed by Section 532 is essentially factual and the findings and conclusions of the district court should not be disturbed by this court unless we find them to be clearly erroneous. *See Commissioner* v. *Duberstein*, 363 U. S. 278 (1960); *Smoot Sand & Gravel Corporation* v. *C. I. R.*, (4th Cir. 1960) 274 F. 2d 495, 501.

Upon examination of the record and consideration of the briefs and oral argument, we conclude that upon the facts of this case the conclusions of the district court cannot be characterized as clearly erroneous. Accordingly, for reasons sufficiently stated in the opinion of the district court[4] the judgment in favor of the taxpayer will be affirmed.

AFFIRMED.

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1. 26 U.S.C. §§ 531-537.
2. 26 U.S.C. § 532.
3. 26 U.S.C. §§ 533 and 537.
4. American Trading and Production Corporation v. United States, ... F. Supp. .....

APPENDIX IV

A. In the following cases, the taxpayers held appreciated securities; and after consideration of the issue the courts reached varying conclusions as to whether such assets should be taken into account on a cost (earnings and profits) basis or at market value for purposes of determining the applicability of the section 533(a) tax avoidance presumption.

1. *American Trading & Production Corp.* v. *United States*, 362 F.Supp. 801 (D.Md. 1972), *aff'd* 474 F.2d 1341 (4th Cir. 1973).
2. *Golconda Mining Corp.*, 58 T.C. 736 (1972), on appeal (9th Cir. Appeals Nos. 72-3202, 73-1161 and 73-1162).
3. *Harry A. Koch Co.* v. *Vinal*, 228 F.Supp. 782 (D.Neb. 1964).
4. *Starks Building Co.*, 32 T.C.M. 1201 (1973).
5. *Henry V. Hummell, Inc.*, 23 T.C.M. 1765 (1964).

B. In the following cases the taxpayers' balance sheets showed that marketable securities were held by the taxpayers, but there was no discussion by the court of the appropriate measure for taking such assets into account for purposes of determining the applicability of the section 533(a) tax avoidance presumption.

1. *Cheyenne Newspapers, Inc.* v. *Commissioner*, 494 F.2d 429 (1974).
2. *Apollo Industries, Inc.* v. *Commissioner*, 358 F.2d 867 (1st Cir. 1966).

3. *Smoot Sand and Gravel Corp.* v. *Commissioner*, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960).
4. *E-Z Sew Enterprises, Inc.* v. *U.S.*, 260 F.Supp. 100 (D.Mich. 1966).
5. *Fenco, Inc.* v. *U.S.*, 234 F.Supp. 317 (D.Md. 1964), *aff'd*, 348 F.2d 456 (4th Cir. 1965).
6. *Delaware Trucking Co., Inc.*, 32 T.C.M. 105 (1973).
7. *Mimmac Corp.*, 31 T.C.M. 375 (1972).
8. *Federal Ornamental Iron and Bronze Co.*, 28 T.C.M. 391 (1969).
9. *Novelart Manufacturing Co.*, 52 T.C. 794 (1969), *aff'd*, 434 F.2d 1011 (6th Cir.), *cert. denied*, 403 U.S. 918 (1970).
10. *Carolina Rubber Hose Company*, 24 T.C.M. 1159 (1965).
11. *Sandy Estate Co.*, 43 T.C. 361 (1964).
12. *Breitfeller Sales, Inc.*, 28 T.C. 1164 (1957).
13. *Hansen Baking Co.*, 12 T.C.M. 685 (1953).
14. *Crawford County Printing and Publishing Co.* v. *Commissioner*, 17 T.C. 1404 (1952).
15. *Metal Office Furniture Co.*, 11 T.C.M. 1066 (1952).
16. *Hut Neckwear Co.*, 10 T.C.M. 801 (1951), *aff'd*, 205 F.2d 152 (2d Cir. 1953).
17. *Lion Clothing Co.*, 8 T.C. 1181 (1947).
18. *Syracuse Stamping Co.*, 4 T.C.M. 371 (1945).
19. *Walkup Drayage and Warehouse Co.*, 4 T.C.M. 695 (1945).

20. *John F. Boyle Co.*, 3 T.C.M. 1335 (1944).

21. *Whitney Chain and Mfg. Co.*, 3 T.C. 1109 (1944), *aff'd*, 149 F.2d 936 (2d Cir. 1945).

22. *Baker and Co., Inc.*, 2 T.C.M. 827 (1943).

23. *Bosch Brewing Co.*, 47 B.T.A. 1043 (1942), memorandum opinion reprinted in Prentice-Hall 1942 B.T.A. Memo. ¶42,429 (1942).

24. *A & J, Inc.*, 38 B.T.A. 1248 (1938).